Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Uniform Issue
0414.09-00

199919041

Person to Contact:

Telephone Number:

Refer Reply to:
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Date:
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Attn:

LEGEND:

State A =
Employer M =
Plan X =

Gentlemen:

This is in response to a ruling request dated July 22, 1998, submitted on your behalf by your authorized representative, concerning the federal income tax treatment, under section 414(h)(2) of the Internal Revenue Code ("Code"), of certain contributions to Plan X including contributions to purchase additional years of credited service.

The following facts and representations have been submitted:

Employer M, a municipality of State A, is a participating employer in Plan X, a defined benefit plan established under state law and adopted pursuant to a municipal ordinance. Plan X is funded through a combination of employer and mandatory employee contributions. Prior to 1991, mandatory contributions were contributed by employees on an after-tax basis. Effective in 1991, Plan X was amended to provide that employee mandatory contributions would be picked up under section 414(h) of the Code. In a letter ruling dated November 21, 1991, issued to Employer M with respect to Plan X, the Service concluded that amounts picked up by Employer M on behalf of those employees who participate in Plan X shall be treated as employer contributions and will not be includible in the employee's

gross income in the year in which such amounts are contributed.

In 1993, as a result of collective bargaining, Employer M agreed to amend Plan X to permit covered employees to purchase up to two additional years of credited service on a pre-tax basis, conditioned upon receiving a favorable private letter ruling from the Internal Revenue Service permitting pick-ups of the employee contributions for the purchases of additional service. In addition to amending the plan, Employer M proposes to adopt a resolution providing, with regard to these employee contributions, that (1) an employee may enter into a binding irrevocable payroll deduction authorization, (2) the employee shall not have the option of choosing to receive the amounts directly instead of having them paid by Employer M, and (3) the employee shall have the amounts of such employee contributions picked up by Employer M.

Based on the foregoing facts and representations, you request rulings:

(1) That the proposed amendment of Plan X and proposed resolution thereto satisfy the requirements of section 414(h)(2) of the Code.

(2) That no part of Plan X contribution amounts picked up by Employer M on behalf of covered employees will be includible as gross income for federal income tax purposes in the year of contribution with respect to such employees.

(3) That the contributions, whether picked up by payroll deduction, offset against future salary increases, or both, and though designated as employee contributions, will be treated as employer contributions for federal income tax purposes.

(4) That no part of the contributions picked up by Employer M on behalf of its employees pursuant to the proposed amendment and resolution will constitute wages from which federal income taxes must be withheld.

Section 414(h)(2) of the Code provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan described in section 401(a), which was established by a state government or a political subdivision thereof, and are picked up by the employing unit.

The federal income tax treatment to be accorded contributions which are picked up by the employer within the meaning of section 414(h)(2) of the Code is specified in Revenue Ruling 77-462, 1977-2 C.B. 358. In that revenue ruling, the employer school district agreed to assume and pay the amounts employees were required by state law to contribute to a state pension plan. Revenue Ruling 77-462 concluded that the school district's picked-up contributions to the plan are excluded from the employees' gross income until such time as they are distributed to the employees. The revenue ruling held further that under the provisions of section 3401(a)(12)(A), the school district's contributions to the plan are excluded from wages for purposes of the collection of Income Tax at Source on Wages; therefore, no withholding is required from the employees' salaries with respect to such picked-up contributions.

The issue of whether contributions have been picked up by an employer within the meaning of section 414(h)(2) of the Code is addressed in Revenue Ruling 81-35, 1981-1 C.B. 255 and Revenue Ruling 81-36, 1981-1 C.B. 255. These revenue rulings established that the following two criteria must be met: (1) the employer must specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee; and (2) the employee must not be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the pension plan. Furthermore, it is immaterial, for purposes of the applicability of section 414(h)(2), whether an employer picks up contributions through a reduction in salary, an offset against future salary increases, or a combination of both.

The proposed amendment of Plan X and proposed resolution satisfy the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that Employer M will make contributions in lieu of the employees' contributions and that the employees shall not be given the option to receive such contributions directly.

Accordingly, we conclude that:

With regard to the first ruling requested, the proposed amendment to Plan X and proposed resolution satisfy the requirements of section 414(h) of the Code.

With regard to the second and third rulings requested, the amounts picked up by Employer M on behalf of covered employees, whether by payroll deduction or otherwise, will

be treated as employer contributions and will not be includible in the participants' gross income for the year in which such amounts are contributed.

With regard to the fourth ruling requested, since we have determined that the picked-up amounts are to be treated as employer contributions, they are excepted from wages as defined in section 3401(a)(12)(A) of the Code for federal income tax withholding purposes. Therefore, no withholding of federal income tax is required from the participants' salaries with respect to such picked-up amounts.

These rulings apply only if the effective date for the commencement of the proposed pick-up is not earlier than the the later of the date the proposed amendment to Plan X and the proposed resolution are signed or the date they are put into effect.

No opinion is expressed as to whether the amounts in question are subject to tax under the Federal Insurance Contributions Act. No opinion is expressed as to whether the amounts in question are paid pursuant to a "salary reduction agreement" within the meaning of section 3121(v)(1)(B) of the Code.

These rulings are based on the assumption that Plan X will be qualified under section 401(a) of the Code at the time of the proposed contributions.

A copy of this letter has been sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,

John Swieca

John Swieca
Chief, Employee Plans
Technical Branch 1

Enclosures:
Copy of this letter
Deleted Copy of this Ruling
Notice 437

cc: